Municipal Bonds

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IN preparing this article upon the issuance of municipal bonds by states, counties, cities and other political subdivisions of the United States, it has been necessary to take into consideration limitations of space and time. The subject is so complex that it is utterly impossible, without writing volumes, to give a detailed and comprehensive outline of the theory and practical working out of the issuance of municipal bonds. In any consideration of this subject, or any phase thereof, it should be remembered that the present system of municipal financing is a typical illustration of the evolutionary process in which necessity and environment combine to produce a desired result.

Definition and Classification of Municipal Bonds

A definition has been called the result of an attempt to condense volumes into one or two short statements —in this case a most unsatisfactory procedure. We may, however, characterize municipal bonds as the obligations—the promises to pay— voluntarily assumed, of definite governmentalities, and payable from taxes. Again, we may say that municipal bonds are the means through which improvements, whose benefit is of a public nature, are financed.

Municipal bonds may be classed in two or three ways, namely, according to the purpose of their issuance, or with reference to the laws affecting their issuance, or from the standpoint of the community incurring the debt. Here we will discuss municipal bonds from the latter standpoint.

National Bonds

The term "municipal" has been diverted from its limited meaning to include that which pertains to any district, city, state or nation functioning as an independent body. Even as the bonds of a city are the obligations of an independently functioning body, or as the obligations of smaller governmentalities are classed as municipal bonds, so are the obligations of the federal or main government placed under the same heading. Each is voluntarily voted by the people, or by their representatives, and is payable from revenues derived from the people. The underlying fundamental concept is the same. The taxpayers voted the bonds of the nation when they voted favorably on the Constitution, endowing Congress with the power to authorize the issuance of federal bonds.

State Bonds

State bonds represent the transition between Federal and public bonds of lesser governmentalities, such as cities, counties, school districts, improvement districts, etc. In practically every state today a loan, pledging the faith and credit of that state, must be authorized and voted by a direct vote of

the people themselves, although in isolated cases the legislatures of states may have the power to issue bonds, their authority having been obtained from a constitutional amendment or, in the last analysis, by a favorable vote of the taxpayers of the state. Like the obligations of the federal government, state bonds need not have a specific tax levied for their payment, but may be paid from the general revenues of the state. More and more is it deemed proper to liquidate state loans, primarily, from certain specific revenues which the state enjoys, although, generally speaking, in the last analysis those loans are supported by the taxing power of the state.

County, City and Town Bonds

County, city, village and town bonds, practically without exception, are voted by the taxpayers themselves and are authorized by a favorable vote at an election held for that specific purpose. In the majority of cases, a definite, irrevocable tax, sufficient for the liquidation of the debt incurred, is levied against all taxable property at the time of the issuance of the bonds. However, as in the case of many state bonds, specific revenues of counties, cities, villages and towns furnish the primary means for the payment of debts incurred for revenue producing improvements.

School Bonds

School bonds are often issued by cities themselves and as such are direct city obligations. There is a second method, however, of issuing school bonds, namely, through the formation of a school district which may consist of an entire city or a part thereof, or of the city plus adjacent territory. Whatever the component parts may be, the district itself is formed voluntarily by the taxpayers therein, according to the existing laws of their state, and in practically every state it is necessary that school debts be created by popular vote of those who will have to pay them. But in a few isolated cases the administrative body of the school district has the power to issue bonds without a vote of the people, being limited either as to the amount of indebtedness that may be incurred or else as to the amount of tax available to pay the total debt, which in effect is an estoppel of the issuance of bonds beyond a certain specific amount.

District Bonds

By far, the most important class of bonds in any discussion of obligations of minor municipalities, such as districts, is the class issued to finance improvements whose benefit is practically localized. This class of municipal bonds will be discussed later, but it may be noted here that the districts standing sponsor for the payment of bonds of this character are always formed with the approval of the property owners therein.

So far, two fundamentals of all municipal bonds have been emphasized; first, their voluntary assumption by the taxpayers, either through a direct expression or through an expression of the representatives of the taxpayers, and, second, their payment from taxes or other revenues derived from those who expressed their willingness to assume the indebtedness. A part of the taxes from practically every taxpayer goes to pay the prin-

cipal and interest of bonds issued by the community in which that person lives. No corporation, other than charitable or religious, and no individual having property, escapes. It has been remarked that the only certainties in the world are death and taxes.

METHODS OF FINANCING

Municipal Property Tax.—Any discussion of Municipal Bonds would be incomplete without a discussion of methods of payment. The majority of municipal bonds are payable from the collection of taxes levied upon property within the municipality creating the debt. Sometimes the taxes are collected by a levy on all of the property assessed; in other words, by an *ad valorem* tax levied in ratio to the assessed value of the taxable property—so many cents for each one hundred dollars assessed valuation. This tax is levied against all assessed property, real and personal, land and money. It is irrevocably levied simultaneously with the issuance of the bonds, and is pledged for the payment of principal and interest thereof and may be used for no other purpose.

Community Property Tax.—Many municipal bonds, especially those issued in late years, are payable only, in their last analysis, from the levy of a tax against the property embraced within the community. Bonds payable in this manner are termed *General Obligations* in contrast to *Direct Obligations*, the name applied to bonds payable by a direct *ad valorem* tax upon all taxable property within the issuing community. The so-called general obligation bond is usually issued for some special purpose or improvement, and is payable from special taxes or from revenues derived from the improvement itself. Only when these funds fail or prove insufficient must the entire municipality, standing sponsor for the debt, assume its burden and liquidate the insufficiency from general revenues or from special taxes which may be levied. Examples of financing of this character are bonds issued for terminal facilities, for the improvement of streets, for waterworks purposes, for agricultural credits, and so forth. Summing up, it may be said that a general obligation bond is one not primarily payable from the taxing power of the community creating the debt, but actually payable, in its last analysis, in that manner.

Special Assessment Bonds.—The least known form of municipal financing is that of obtaining improvements, whose benefit is entirely local, by the issuance of bonds whose principal and interest are payable from a special tax levied upon the property benefited in proportion to the benefits that will accrue to the property taxed. This form of municipal financing is the result of conditions found, for the most part, in the middle west, although to some extent in other parts of the United States. The draining of lands not sufficiently rolling to carry off surplus rain water, the construction of levees to protect fertile lands from rivers and streams in their flood stages, the construction of roads to furnish at all times an outlet to the shipping point for products of the community, are causes which have called forth what is known as *Special Assessment* financing. This form of financing, although comparatively new, is sufficiently old to have proven its merit.

The majority of municipal bonds are evidences of debt incurred, presumably, for the benefit of all of the residents of a municipality. They are issued to finance the very purposes for which the municipal government exists. Often, however, there are communities and districts, not organized as one of the usual political subdivisions of the state, which, because of their location or the peculiar physical conditions obtaining, necessitate special financing in order to provide local improvements. Accordingly, these communities or districts are organized under Enabling Acts which exist in almost every state solely for the purpose of financing and constructing the proposed improvement. If the improvement is such that it will operate to the benefit of all of the residents of the community, then the statutes more often provide that the bonds issued to pay for the improvement shall be payable by a tax levied against all of the property in the district. If, on the other hand, the improvement is such that it will benefit one class of property owners more directly and in greater proportion than the remainder, then it is equitable and fair that the property thus benefited should pay the cost of the improvement. Consequently, there are in most of the states statutes which provide for the organization of a district or municipality for the purpose of constructing an improvement whose cost shall be paid by the property specially benefited. Bonds issued by those districts, which are payable by a tax levied against the property benefited and in proportion to the manner in which it is benefited, are known as *Special Assessment Bonds*, the most typical examples of which are drainage, levee and road improvement district bonds.

Land in a district subject to overflow, or land which is poorly drained or has roads inadequate to allow the products thereof to be marketed readily, will be increased intrinsically in value if the necessary improvement is secured. The benefit to this land is direct and much greater than to any other class of property. It is obvious that the land should bear the burden of the cost, yet, it is equally apparent that, in order to provide an opportunity to secure the money for the improvement and at the same time furnish the necessary safeguards to the land owner as well as to the purchaser of the security, it is essential that many legal proceedings be performed and judicially confirmed.

Method of Forming Bond Districts

The method of the formation of a district and the steps necessary to be taken before bonds can be issued vary to some degree in the different states, but the idea is the same. Only a general theory of the procedure can be indicated here. The organization of such a district is accomplished either by a special act of the legislature or by compliance with a general act; but in either case the organization of the political subdivision is with the consent of those who will enjoy the benefit from the proposed improvement and will consequently bear the cost thereof.

After the formation of the district, plans for the desired improvement are formulated and adopted after their correctness has been established to the satisfaction of property owners. The cost of the improvement is estimated at the time the plans are made, and if the

proposed improvement is found to be too expensive, the project, of course, is abandoned; but it is generally known, before the district is organized, just about what will be the cost of the improvement. Then disinterested persons are appointed to go upon the land affected by the improvement and determine the benefits that will accrue thereto by reason of the accomplishment of the proposed improvement. The benefits, so estimated, are adjudicated to the satisfaction of the owners of the lands that will be benefited, and after the benefits have been so adjudicated and sufficient time has been given in which they may be attacked, they stand as an immovable basis for the financing of the district. Assessed valuations fluctuate, but benefits, once confirmed after their adjudication, cannot be lowered or in any way changed, except in rare cases where benefits against individual tracts may be changed, provided the change does not at all affect the total amount of benefits confirmed; *i.e.*, if any benefits are lowered, others must be raised proportionately so as not to affect the total. Throughout the procedure of the assessment and confirmation of the benefits, the property owners affected have ample time in which to appeal from the benefits assessed. Thus, when the benefits are finally confirmed it means that the confirmation comes after the interest of those affected has been entirely safeguarded. It is important, in connection with the assessment of benefits, to bear in mind that benefits are assessed with the consent of the property owners, or after it has been proven that their dissatisfaction is not justly founded.

When the benefits have been confirmed, the next step is to advertise for bids for the doing of the work, according to the adopted plans for the improvement. When the exact cost of the work has been ascertained, through letting a contract, a tax is levied to cover that cost. Time is given the property owners to pay their part of that tax in cash, and if they do not choose to do so, bonds are then issued to produce the money necessary to pay for the cost of the improvement. The bonds so issued are payable from the collection of the taxes levied against the property benefited, and in proportion to the manner in which the court has confirmed the benefits. The taxes, from which the bonds are payable, are irrevocably levied at the time the bonds are issued, and usually exceed the requirements for principal and interest by a safe margin. Taxes so levied are usually on a parity with taxes levied for state and county purposes and, in most cases, are collected in the same manner and at the same time as state and county taxes.

The creation of special assessment debts requires experience in municipal financing, as well as a knowledge of the needs and problems of the community affected, but when correctly and intelligently constructed, special assessment debts should be liquidated as promptly as direct obligation, general obligation, or other classes of municipal bonds. The administration in districts issuing special assessment bonds is generally as efficient as in other municipalities, because in such districts the largest property owners generally advocate the improvement and take a leading part in obtaining it and maintaining its efficiency. Volumes might be written on special assessment financing

since, although the idea is practically uniform throughout the United States, the technique of the creation of the debts varies so greatly in different localities.

Municipal Bonds a Barometer of Progress

Municipal bonds have been called the barometer of progress. They are indicative of the spirit of a community. As industrial development proceeds and as population increases, new facilities become necessary. Good roads or paved streets are needed, increased school facilities are demanded, court houses and city halls must be enlarged or built, waterworks must be established or extended, lands heretofore unproductive must be made to produce food and basic materials. All of these projects are usually carried through by the issuance of municipal bonds. The growing industries, the producing farms and the new homes all become the security behind the bonds. Municipal bonds, whether of the direct obligation, the general obligation, or the special assessment class, are a prior lien to all private obligations, and their prompt payment is dependent not on a small group, but upon the community whose welfare is irrevocably yoked to the maintenance of proper credit.

In concluding this statement on municipal financing, it is proper to mention the matter of *value received.* It would be folly to purchase any securities, the technique of whose issuance did not correspond exactly to that prescribed by law, but it would be equally foolish to purchase municipal securities that were issued for other than a meritorious purpose, or for any purpose not calculated to benefit the community creating the debt. History furnishes but rare instances of a public community in the United States refusing to repay, with the agreed interest, that which it contracted to pay, and in return for which the proper value was received. Municipal financing, in its last analysis, rests upon the credit of a community, and the credit of a community is determined as much by its integrity and willingness to liquidate its debts as by its ability to do so.

It is well to remember that we in this country are in the initial stages of municipal financing. As life becomes more complex, as the demand for food and clothing becomes greater, and as the demand for the enjoyments of life becomes more pronounced, the creation of debts by public communities will be increased correspondingly; and with that increase we will discover new and improved methods of providing the necessary funds. Of late years practically all municipalities are adopting the method of paying their debts year by year, so an increase in the output of municipal bonds should not be alarming as the outstanding amount is constantly being liquidated. If I were asked to state the determining factors of a safe municipal bond, my experience would prompt me to say, a needed improvement, an honest community and a proper construction of the debt.